Supreme Court, U.S.
FILED
SEP 19 1980
MICHAEL RODAK, JR.

No. 79-1515

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

UNITED STATES OF AMERICA, *Petitioner,*

v.

ELWOOD SWANK AND RITA SWANK

UNITED STATES OF AMERICA, *Petitioner,*

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, *Petitioner,*

v.

BULL RUN MINING CO., INC.

On Writ Of Certiorari To The United States Court Of Claims

BRIEF FOR RESPONDENT BULL RUN MINING CO., INC.

WOODROW A. POTESTA
Suite 510
First National Bank Building
Fairmont, West Virginia
(304) 366-0470
Attorney for Respondent

On Brief:
ROBERT LATHROP

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

TABLE OF CONTENTS

	Page
Statutes And Regulations Involved	1
Statement Of The Case	2
Summary Of Argument	4
Argument	6
I. A Bilateral Thirty-day Written Notice Termination Clause Is Only One Of Several Factors, Not The Controlling Factor, To Be Considered In Determining Whether A Lessee Has The Requisite Economic Interest To Title It To The Depletion Allowance	6
II. Termination Clauses Of The Type In Question Here Do Not Invalidate An Otherwise Admittedly Legitimate Economic Interest Where The Taxpayer Clearly Has Acquired An Interest In The Minerals In Place Pursuant To A Lease, As Lessee, And Must Look To The Market To Recover Its Investment In The Minerals In Place	13
III. Economic Reality Is The Touchstone In All Tax Cases	23
IV. The Lessor Has Not Claimed Any Depletion Allowance With Respect To The Coal Mined By The Lessee During The Tax Year In Question: Hence The Lessee Is Entitled To The Depletion Allowance Since Congress Did Not Intend That No One Be Able To Claim The Depletion Allowance	25
Conclusion	27
Appendix	1a

TABLE OF AUTHORITIES

CASES: PAGE

Bakertown Coal Co. v. *United States*, 485 F.2d 633 ... 3, 10, 14, 21, 24

Costantino v. *Commissioner*, 445 F.2d. 405 16

Holbrook v. *Commissioner*, 65 T. C. 415 17

Huss v. *Smith*, 255 F.2nd 599 9

McCall v. *Commissioner*, 312 F.2d 699 15

Mullins v. *Commissioner*, 48 T.C. 571 ..... 11, 14, 17, 21

Palmer v. *Bender*, 287 U.S. 551 ..... 6, 7, 18, 19, 20, 22

Paragon Jewel Coal Co. v. *Commissioner*, 380 U.S. 624 ..... 12, 15, 26

Parsons v. *Smith*, 359 U.S. 215, aff'd 255 F.2d 595 ..... 7, 8, 9, 10, 15

Thornberry Construction Co., Inc. v. *United States*, 576 F.2d 346 14

United States v. *Biwabik Mining Co.*, 247 U.S. 116 6

United States v. *Stallard*, 273 F.2d 847 15

United States v. *Wade*, 381 F.2d 345 16

Weaver v. *Commissioner*, 72 T.C. 594 ..... 17, 21

Whitmer v. *Commissioner*, 443 F.2d 170 ..... 17, 19, 21

Winters Coal Co. v. *Commissioner*, 496 F.2d 995 ..10, 14, 21

STATUTES AND REGULATIONS:

Internal Revenue Code of 1954, as amended (26 U.S.C.):

Section 611(a) 4, 6, 12, 18, 1a

Section 611(b) (1) 25, 1a

Section 613 ..... 4, 12, 19, 26, 1a

Section 613 (a) 18, 1a

Section 631 (c) 2, 5, 25, 26, 27, 2a

Revenue Act of 1951, Section 325, 65 Stat. 452. 26

Table of Authorities Continued

MISCELLANEOUS:	PAGE
G.C.M. 26290, 1950-1 Cum. Bull. 42	20
Rev. Rul. 70-277, 1970-1 Cum. Bull. 280	20
Rev. Rul. 77-481, 1977-2 Cum. Bull. 205	20
Section 1.611-1(a)(1)	6, 18, 3a
Section 1.611-1(b)(1)	6, 3a
Section 1.611-1(b)(2)	26, 4a
Section 1.611-2	18

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No.79-1515

UNITED STATES OF AMERICA, *Petitioner,*

v.

ELWOOD SWANK AND RITA SWANK

UNITED STATES OF AMERICA, *Petitioner,*

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, *Petitioner,*

v.

BULL RUN MINING CO., INC.

On Writ Of Certiorari To The United States Court Of Claims

BRIEF FOR RESPONDENT BULL RUN MINING CO., INC.

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations referred to by petitioner, Section 631(c) of the Internal Revenue Code of 1954, as amended (26 U.S.C.), is set forth in the Appendix, *infra,* at 1a.

STATEMENT OF THE CASE

Bull Run Mining Co., Inc., was engaged in mining coal in West Virginia during its tax year ending September 30, 1974. The mining was conducted under a lease agreement, dated June 21, 1967, between respondent as lessee and Preston County Coal and Coke Corporation as lessor (J.A. 90a). The lease was for a five-year term, renewable for an additional five years. The lease was in fact renewed for that additional five years plus a second five years. The renewal option in the lease was conditioned upon all of the coal not having been removed at the end of the original term of the lease. While the record indicates that respondent still is mining coal under the second five-year renewal (Br. in Opp. 10), in fact under the lease in question the coal was mined to exhaustion as of September 15, 1978, and the mine was sealed and approved by the West Virginia Department of Mines on September 30, 1978. This had not occurred either at the time respondent's petition was filed with the United States Court of Claims which was on July 27, 1977 (J.S. 87a) or at the time the depositions of respondent's witnesses were taken on April 26, 1978.

By the terms of the lease respondent had the right to mine coal on specified lands on condition that it pay a royalty to the lessor of 25 cents per ton of coal removed. Respondent was entitled to sell the coal which it mined under this lease to anyone for any price which it should choose without any restrictions or oral understanding between the lessor and the lessee (J.A. 91a). However, during the particular tax year involved respondent sold all the coal which it mined pursuant to the lease to the lessor because the lessor at that time presented the most favorable market for the lessee. In

other years, respondent sold the coal to buyers other than the lessee (Br. in Opp. 10-11; Repl. Br. to Cr. Mot. 3-6).

The proceeds from the sale of the coal represented the only source of revenue from which respondent could recover any rents and royalties paid to the lessor for the right to mine (J.A. 91a).

Pursuant to the lease, either party could terminate the lease within thirty days upon written notice (J.A. 96a). Also, pursuant to the lease, the lessee was obligated to mine in such a way that it would comply with West Virginia and United States law relating to mining, be an independent contractor, insulate the lessor from liability, and operate the mine in a workmanlike fashion so as to maximize production (J.A. 95a-96a). If any of those conditions were breached, the lease could be cancelled by the lessor wholly apart from the thirty-day termination clause. The thirty-day termination clause never was exercised; the lessee mined the coal to exhaustion under the lease from 1967 to the end of 1978.

On its federal income tax return for its tax year ending September 30, 1974, respondent claimed a depletion deduction of $39,981.41 with respect to the coal which it mined as lessee (J.A. 92a-93a). The lessor has not claimed any depletion allowance with respect to the coal mined by respondent during the tax year in question (J.A. 92a).

Petitioner's brief adequately covers the proceedings below regarding respondent. It should be pointed out, however, that the Court of Claims' decision in *Bakertown Coal Co.* v. *United States,* 485 F.2d 633 (1973), was rendered by the court sitting en banc with only one

dissent and not by a court closely divided. The court in *Bakertown* consisted of seven judges.

SUMMARY OF ARGUMENT

1. A bilateral thirty-day written notice termination clause of the kind in question here is only one of several factors, not the controlling factor, to be considered in determining whether a lessee has an economic interest in the coal in place so as to entitle it to the depletion allowance provided by Sections 611(a) and 613 of the Internal Revenue Code of 1954, as amended. Because the effect of such a clause on an otherwise admittedly depletable interest is the only issue on appeal, it is not necessary to delve into what the other factors may be or whether they are met, the government having conceded that all other factors necessary to establish an economic interest in respondent exist. If this Court should find that the termination clause is only one of several factors to review in determining whether an economic interest exists, then the judgment below should be affirmed.

2. Termination clauses of the type in question here do not invalidate an otherwise admittedly legitimate economic interest where the lessee clearly has acquired an interest in the mineral in place pursuant to a lease, as lessee, and must look to the market to recover its investment in the minerals in place. Most of the cases involving termination clauses of the kind in question here, where the depletion deduction was denied, are readily distinguishable on their facts, for there usually was at least one other factor which led the court to deny the depletion allowance. In those cases where no factual distinction can be made from the case at bar, or where it might appear that there was no factual distinction, the analysis of the lower court was in error as to the effect

of such a termination clause with respect to the acquisition of an economic interest. This has been caused in part by confusing the concept of cost or discovery depletion with percentage depletion.

3. Economic reality is the touchstone in all tax cases. The termination clause at issue never in fact was exercised over the period during which respondent mined the coal to exhaustion under the lease. Clearly the lessee had an interest in fact which permitted it to mine the coal to exhaustion. If, and until, the termination clause was exercised, respondent had an economic interest under the lease.

4. The lessor has not claimed any depletion allowance with respect to the coal mined by the lessee during the tax year in question. In fact, the lessor is prevented from so doing by reason of Section 631(c) of the Internal Revenue Code of 1954, as amended, because the lessor has treated receipt of the royalty payments under the lease as a sale. It was never the intent of Congress that no one be able to claim the depletion allowance. Should the government prevail in its position, no person would be able to claim the allowance. Because of the operation of Section 631(c) of the Internal Revenue Code of 1954, as amended, precluding the lessor from claiming the depletion allowance, the lessee is the only person who is entitled to claim it.

ARGUMENT

I. A Bilateral Thirty-Day Written Notice Termination Clause Is Only One Of Several Factors, Not The Controlling Factor, To Be Considered In Determining Whether A Lessee Has The Requisite Economic Interest To Entitle It To The Depletion Allowance

A deduction for depletion is allowed by Section 611(a) of the Internal Revenue Code of 1954, as amended, "according to the particular conditions in each case" under regulations prescribed by the Secretary of the Treasury. Treas. Reg. Sec. 1.611-1 Appendix, *infra,* at 3a, sets forth the general conditions for the allowance of depletion. Treas. Reg. Sec. 1.611-1(b)(1), Appendix, *infra,* at 3a, states that depletion will be allowed only to the owner of an economic interest.

The concept of an economic interest as a condition to taking depletion was first enunciated in *Palmer* v. *Bender,* 287 U.S. 551 (1933). At 557 in *Palmer*, this Court set forth the test so often quoted:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

The Court went on to say in discussing *United States* v. *Biwabik Mining Co.,* 247 U.S. 116 (1918):

> But this Court held that regardless of the technical ownership of the ore before severence, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his

> mining rights under the lease. Depletion was, therefore, allowed.

It is clear that the concept of an economic interest was incorporated in the regulations from the *Palmer* case. It is equally clear that this Court in *Palmer* intended the concept of an economic interest to be construed broadly. Based on the regulation as it stands, and on *Palmer*, where the taxpayer claiming depletion must look to the market place for a return of its capital investment, and where it holds rights to the mineral in the ground as a lessee pursuant to a bona fide lease, the taxpayer on those basis alone is entitled to the depletion deduction.

Even though the government's brief at pages 15-18 suggests that this Court has decided cases supporting the government's position, this Court has not been presented with a case involving a short-notice at will termination clause where the taxpayer was clearly a bona fide lessee as opposed to a mining contractor performing mining services for the owner of the coal. Nor is there anything in the Internal Revenue Code of 1954, as amended, or the Treasury Regulations to lend guidance in this type of fact situation.

Parsons v. *Smith,* 359 U.S. 215 (1959) is the only case in which this Court has dealt squarely with the effect of a short-notice at will termination clause in determining whether the taxpayer had an economic interest. In *Parsons,* at 225, the Court set forth seven factors which were indicia of an economic interest:

> To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable — not in the coal in place; (2) that their investments in equipment were recoverable through depreciation — not

depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in Huss, agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work;" and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts.

The *Parsons* Court held that the taxpayer there met not one of these factors and thus did not have an economic interest in the coal in place. Unlike respondent here, Parsons was primarily a road building contractor and wanted to return to roadbuilding should an opportunity open up; hence, the termination clause. The agreement between Parsons and the owner of the coal was that Parsons would furnish its own equipment at its expense, as well as the facilities and labor to strip mine the coal, and then deliver the coal to the owner's cars. Parsons was to be paid a stated amount of money per ton by the owner, but Parsons was not permitted to keep or sell any of the coal on the open market. The agreement regarding termination was open-ended. As the Court noted at 217:

> [I]t was agreed that 'if Parsons or Rockhill wanted to quit, all that was necessary to terminate the arrangement was the giving of a ten day notice'

In the companion case of *Huss* v. *Smith,* 255 F.2nd 599, there was a written contract between the owner and Huss to strip mine certain coal. As in *Parsons,* Huss was to furnish at its own expense all the equipment, facilities and labor, was to deliver all coal mined to the owner who would pay Huss a stated sum per ton. As in *Parsons,* Huss was not permitted to sell the coal on the open market. There was a termination clause pursuant to which the owner/lessor at any time with thirty days written notice could terminate the arrangement without cause. The monies that were to be paid to both Parsons and Huss by the respective owners of the coal "was agreed to be in 'full compensation for the full performance of all work and for the furnishing of all material, labor, power, tools, machinery, implements and equipment required for the work.' " at 218.

In holding against the taxpayers in *Parsons,* this Court looked at all seven factors, found that the taxpayers failed them all, and concluded that the taxpayers involved were merely contract miners who had to look to the owners for payment for the work done and therefore bore no risk of the market and thus had no investment in the coal in place. Hence, said the Court, they were paid by the coal owners for their services in mining the coal for the owners rather than for their own benefit. The major distinguishing factor between the case at hand and *Parsons* is that the taxpayers in *Parsons* bore no risks of the market and therefore had no indicia of having made any kind of investment in the mineral in place to which they would have to look as an owner of such an interest to recover that investment. In the case at hand, it is clear that respondent bore all the risks of the market to recover its investment in the coal in place, as a lessee, and therefore had the kind of proprietary interest which has always been associated with

an economic interest. In any event, to the *Parsons* Court, the termination clause was only one of several factors to consider in determining whether the taxpayers had an economic interest so as to entitle them to the depletion deduction.

Winters Coal Company, Inc. v. *Commissioner,* 496 F.2d 995 (5th Cir. 1974), involved a lease very similar to the one in this case. The only issue was whether the termination clause in the lease was enough to deny the taxpayer the depletion allowance. In that case, the lease was automatically renewable every year, but each party had the right to give thirty days' notice of intent not to renew. Furthermore, either party had the right to terminate at will upon sixty days' notice (subsequently reduced to thirty days). The Court found, and the government has virtually conceded the same in the present litigation, that the lease conveyed to Winters Coal Company the rights to the coal in place. Therefore, the only question before the court was whether the termination clause by itself would destroy what was clearly otherwise an economic interest. The court then reviewed the *Parsons* criteria and determined with respect to the short notice termination clause the following at 1000:

> This being the only contra point to the vesting of an economic interest in the petitioner, to say that ABC had not passed an economic interest to Winters pursuant to the leases gallops beyond all reason and logic.

In *Bakertown Coal Company, Inc.* v. *United States,* 485 F.2d 633 (Ct. Cls. 1973), involving leases similar to the one in the present litigation, the Court of Claims indicated unmistakably its view that in dealing with the seven factors set forth in *Parsons* the terminability factor was only one of several to be considered in deter-

mining whether a taxpayer possessed an economic interest so as to entitle it to the depletion allowance. The Court said at 639:

> Though terminability was one of the seven disqualifying factors mentioned, it cannot be considered either in isolation or in the abstract, as the Government would have it. Rather, it is clear that in the context of the contractor-oriented opinion, coming in the wake of G.C.M. 26290 and the decisions that followed it, *the matter of terminability becomes only a colorably relevant factor where the applicant for the allowance lacks the traditional qualifications for depletion, as reflected by the other six conditions referenced by the court.* (Emphasis supplied)

The Court of Claims followed its reasoning in *Bakertown* in the judgment below clearly indicating it viewed the *Parsons* criteria as being a bundle of several different factors, none of which was necessarily controlling, and the terminability factor not even relevant if all other six factors were met. The government has conceded that all other six factors had been met. See the judgment below at 349.

In *Mullins* v. *Commissioner,* 48 T.C. 571 (1967), Judge Drennen in his dissent suggested that the terminability factor is not controlling but is an important factor to consider in determining whether a lessee holds an economic interest. He said with respect to the so-called Bolling lease at 584:

> I agree that the presence of a clause permitting the lessor to terminate the lease without cause on short notice is an important factor to be considered in determining who has the requisite economic interest in the coal under a lease or contract but I do not think it is conclusive, as does the majority [footnote omitted]. In my opinion we should look to the overall purpose of the depletion statute, and all the

> circumstances of the particular transaction, to determine how much weight to give to the termination clause in determining who had the economic interest in the deposit.

Judge Drennen's comments reflect the manner in which the Court of Claims and the Fifth Circuit have approached this problem. His opinion also expresses the generally accepted view of the resolution of tax disputes, namely, that such disposition should be based in economic reality and not in technical legal terms.

It is interesting to note that while this Court in *Parsons* did not regard the presence of terminability as controlling, neither did it regard the absence of terminability as controlling in *Paragon Jewel Coal Company, Inc.* v. *Commissioner,* 380 U.S. 624 (1965). Yet in both cases the percentage depletion deduction was denied to the contract miners involved. The denial was based, then, not on the presence or absence of a terminability clause but on the broader and controlling rationale that the contract miners did not have to look to the market place for a return of their investment. They looked only to the owners for a set return in exchange for the service of mining.

Since the government has conceded that respondent has met all the criteria set forth in *Parsons* except the one involving terminability and since the terminability issue is only significant if other indicia of an economic interest are absent, respondent is entitled to the percentage depletion deduction allowed by Sections 611(a) and 613 of the Internal Revenue Code, as amended.

II. Termination Clauses Of The Type In Question Here Do Not Invalidate An Otherwise Admittedly Legitimate Economic Interest Where The Taxpayer Clearly Has Acquired An Interest In The Minerals In Place Pursuant To A Lease, As Lessee, And Must Look To The Market To Recover Its Investment In The Minerals In Place

Pursuant to the lease between Preston County Coal and Coke and respondent, Preston County Coal and Coke leased to the leasee all of a certain tract of unmined coal and granted the lessee the exclusive right to mine that coal. The mining had to be performed in a good, workmanlike manner so as to mine and remove a maximum amount thereof consistent with modern mining methods. The lessee had to mine pursuant to existing rules and regulations of the United States and West Virginia and any which might be enacted after the effective date of the lease. The lessee also had to comply with all existing Workman's Compensation Laws and save the lessor harmless from any liability arising out of the operation of the mine. The lessee was to operate as an independent contractor. The term of the lease was for five years with an option in the lessee to renew for five years if the coal had not been removed by the end of the original term. The lessee was to pay the lessor a royalty of 25 cents per ton for the coal mined and removed. The parties agreed that upon written notice at least thirty days prior to the effective date of the termination, either party could cancel the lease without cause. The lease was assignable with the prior written consent of the lessor (J.A. 94a-96a).

By the terms of the lease, then, it is clear that the lessee respondent obtained a bona fide leasehold interest

in the coal in place and had to look to the open market to recover its investment in the coal in place. In other words, the lessee bore all the risks of ownership of the minerals in place as the only means by which it could recover its investment. It is precisely leases of this nature under which the lessee was really an entrepreneur, relying on the market to recover its investment as opposed to relying on the lessor for a fixed fee for services of mining, that led the Court of Claims in the instant case, as well as in *Thornberry Construction Co., Inc.* v. *United States,* 576 F.2d 346 (Ct. Cls. 1978), and *Bakertown Coal Co.* v. *United States,* supra, the Fifth Circuit in *Winters Coal Co.* v. *Commissioner,* supra, and Judge Drennen in his dissent in *Mullins* v. *Commissioner,* supra, to hold that an at will terminability clause would not destroy an otherwise valid economic interest so long as the leasehold interest clearly represented an investment in the minerals in place.

All but three of the cases holding that a termination clause of the type at issue here prevents the taxpayer from having an economic interest are distinguishable on their facts. In those cases the taxpayer involved had not an interest which required him to look to production and then sale of the minerals on the open market where he assumed all the risks of ownership to recover his investment. Rather, he was performing services for a set return per unit from the lessor or owner. The difference in those cases from the case at hand is that the taxpayers there were essentially performing services for monies to be paid from other than the open market as opposed to respondent who was an entrepreneur looking to recover its investment in the coal in place on the open market with all its attendant risks.

The only case which has presented this Court with an opportunity to pass on the question of the effect of short notice termination clauses has been *Parsons* v. *Smith,* supra. As noted above, in that case the taxpayer met none of the seven criteria set forth and therefore was denied the depletion allowance. In spite of the government's contention to the contrary at page 18 of its brief, *Paragon Jewel Coal Co.* v. *Commissioner,* supra, dealt only peripherally with the termination clause and based its holding squarely on the fact that the contractors there did not look to the market place for a return on their investment.

In *United States* v. *Stallard*, 273 F.2d 847 (4th Cir. 1959), while there was a thirty-day notice at will termination clause involved and it was held to be of some importance in denying the taxpayer/stripmining contractor the depletion allowance, the other most important factor involved was that the strip miner was only performing mining services because he did not depend on the market place for profit or loss but rather provided all the equipment and labor (very much as occurred in *Parsons* v. *Smith*, supra), mined the coal pursuant to the agreement, and then delivered it to the owner at a fixed price per ton. That is not the case with respect to respondent. Respondent was a bona fide lessee as opposed to a mining contractor, bore the risk of profit or loss of the open market, operated independently of the lessor, and was not subject to any control by the lessor. In short, respondent was not simply performing contract services for the lessor but was the owner of the coal under the lease and bore all the risks and responsibilities of an owner of such an interest.

In *McCall* v. *Commissioner*, 312 F.2d 699 (4th Cir. 1963), a thirty-day at will termination clause was involv-

ed and held to be the critical factor in denying the depletion allowance to the taxpayer. However, the terms of the agreement between the sublessor and the lessee/taxpayer required the lessee to mine the coal and deliver it to the sublessor at a set price per ton. Furthermore, in addition to the right in either party to terminate without cause after thirty days' notice, the sublessor had the right, if economic conditions prevented him from selling the coal mined and delivered by the mining contractor at a reasonable profit, to require the mining contractor to suspend operations upon twenty-four hours' notice. Also, the sublessor reserved the right to strip mine coal which could not be properly mined by the mining contractor through deep mining.

Those factors are not present in this case. Respondent was a bona fide lessee and had acquired all the rights exclusively, without interference or control by the lessor, to mine the coal it owned pursuant to the lease, bore the risks of the market as would any owner of a leasehold interest, and was free to sell to anyone at any price.

In *United States* v. *Wade*, 381 F.2d 345 (5th Cir. 1967), the contract miner there was paid a fixed amount for quarrying dolomite and delivering it to the lessor. He did not rely on the open market for his profit or loss. While the thirty-day notice at will termination clause was deemed to be important, it was not the only factor which caused the court to deny the depletion allowance. Rather, it was one of two major factors, the other one being the fact that Wade essentially provided a mining service.

In *Costantino* v. *Commissioner,* 445 F.2d 405 (3rd Cir. 1971), another thirty-day notice at will termination clause case was presented to the court. However, under

the arrangement between the mining contractor and the owner the mining contractor could look only to the owner for a set price per ton, thus evidencing the fact that the owner had not parted with any interest in the mineral in place but rather had contracted for the "lessee" to perform a mining service in extracting the mineral from the ground. This was one of several factors which caused the court, in addition to the thirty-day notice termination clause, to deny the depletion allowance to the taxpayer. Respondent, on the other hand, owned the leasehold interest, was not under control of the lessor, and bore all the risks of the market to recover its investment in the coal in place.

In *Holbrook* v. *Commissioner*, 65 T.C. 415 (1975), the Tax Court was faced with a thirty-day notice at will termination clause case. However, under the lease between the owner and the lessee/taxpayer title to the coal covered by the lease did not pass until the coal had been reduced to physical possession by the lessee. This factor alone had as much to do with the denial of the depletion allowance, if not more, than the thirty-day notice termination clause. Further, in *Holbrook* the mining right was not exclusive. These facts do not exist in the case at hand; thus *Holbrook* is easily distinguishable.

The three cases which appear to be directly in conflict with the judgment below may to some extent be distinguishable on their facts. However, for purposes of this argument, it is assumed that they are not distinguishable on their facts, at least insofar as the courts involved viewed the facts. The cases are *Weaver* v. *Commissioner*, 72 T.C. 594 (1979), *Mullins* v. *Commissioner*, supra, and *Whitmer* v. *Commissioner*, 443 F.2d 170 (3rd Cir. 1971).

The rational of those cases in holding that the presence of a thirty-day (or other short-term) notice termination clause at will defeats an economic interest is that the grantor or transferor has not really transferred any interest in the minerals in place because the transferee has no right to mine to exhaustion and therefore has no investment in the minerals in place which is the first requirement of *Palmer* v. *Bender*. *Palmer*, however, involved discovery depletion (287 U.S. at 554), which is no longer permitted. See Treas. Reg. Sec. 1.611-1(a)(1), Appendix, *infra*, at 3a. Both cost depletion and discovery depletion require an estimate of the amount of coal in place either at time of purchase or at time of discovery; then the depletion deduction is calculated on a per unit basis. See Treas. Reg. Sec. 1.611-2, *infra*, at 4a. In either case, it is necessary to estimate near the beginning of the mining operation how much coal is in the ground and then base the depletion deduction on that estimate. Where such a depletion method is used, it makes some sense to have a requirement that the person claiming the deduction be able to mine the deposit to exhaustion because the amount of the depletion deduction per unit is based implicitly on that assumption.

However, that is not the case with respect to percentage depletion which has absolutely nothing to do with an estimate of units of coal in the ground. And even though technically cost depletion should be calculated to determine if it exceeds percentage depletion (See Section 613(a) of the Internal Revenue Code of 1954, as amended), Appendix, *infra*, at 1a, as a practical matter this is not done by most taxpayers because of the inherent difficulty in making an estimate of the units which is one reason why Congress enacted percentage depletion.

Percentage depletion operates solely as a percentage of gross income generated through production and sale, and unlike cost depletion, is available to the taxpayer far beyond the time when the initial investment in the mineral has been recovered. See Section 613 of the Internal Revenue Code of 1954, as amended, *infra,* at 1a. Hence, there is no reason with respect to allowing percentage depletion that the person claiming the depletion deduction have the right to mine the deposit to exhaustion. In fact, so long as the person claiming the depletion deduction meets the general test of *Palmer* v. *Bender,* which is that the taxpayer has acquired legal control of a valuable economic interest from which he can realize gross income by exercising his mining rights, the depletion deduction should be available. That is the case with respect to respondent. Thus, in the three cases which appear to be contrary to respondent's position, the requirement of obtaining the right to mine to exhaustion with respect to percentage depletion is misplaced through a loose appliction of the *Palmer* v. *Bender* rule.

Furthermore, if a lease can be terminated for cause, that kind of termination does not destroy an otherwise valid economic interest. See *Whitmer* v. *Commissioner,* supra, and cases cited therein. Yet, if a lease is terminated for cause, nevertheless the lessee will not be able to mine the deposit to exhaustion. If that is true, then there is inconsistent treatment of those two situations unless the key is the fact that the transferor has retained control over the transferee by reason of having the short-notice termination power at will.

However, interpretations of the effect of termination clauses by the Internal Revenue Service indicates that short-notice at will termination clauses will destroy an otherwise valid economic interest, whether they are

exercisable by the transferor or a third party. In G.C.M. 26290, dealing with coal contract miners (as opposed to lessees) originally an at will termination clause for which a year's notice was required was thought to be of such a nature that it would not destroy an otherwise economic interest. An at will termination clause with notice of less than a year was thought to destroy an otherwise valid economic interest because the transferor was not conveying an interest which would permit the transferee to mine to exhaustion; therefore, the transferee had no investment in the mineral in place; therefore, the first requirement of the *Palmer* v. *Bender* rule had not been met. G.C.M. 26290, 1950-1 Cum. Bull. 42, declared obsolete in Rev. Rul. 70-277, 1970-1 Cum. Bull. 280. Strangely enough, though, in Rev. Rul. 77-481, 1977-2 Cum. Bull. 205, the Internal Revenue Service took the position that if the lease could be terminated by some one other than the grantor, there still was no economic interest because of the possibility that the deposit would not be mined to exhaustion by the lessee. The Internal Revenue Service itself, by taking this latter position, invalidates the only distinction to be drawn between termination for cause and termination at will. If the termination is for cause, the rationale for not having such a right destroy an otherwise valid economic interest is that there is no retention by the transferor of some power over the transferee. But, if the termination can be effected at the will of the transferor, then the transferor has retained so much control over the transferee that the transferee for all practical purposes has acquired no substantial interest.

In the instant case, as was pointed out in the judgment below, there is nothing in the record to indicate that the coal could not have been mined to exhaustion within the thirty-day period. In fact the Respondent has

mined to exhaustion all of the coal under the lease as of September 30, 1978. This is hardly a *Parsons* situation where there the contract was oral with a ten day notice of termination designed mostly because the 'lessee' Parsons wanted to be able to terminate the contract as soon as a road building project could be obtained.

Furthermore, in *Weaver, Mullins,* and *Whitmer,* just as with respect to the facts in the case at hand, the right to terminate on short-notice at will was merely a condition subsequent; and until that right was exercised, the lessee had every right, opportunity, and risk in carrying on his operation as a lessee under a lease without such a termination clause. *Bakertown Coal Co.* v. *United States,* supra; *Winters* v. *Commissioner,* supra; *Mullins* v. *Commissioner* (dissent), supra; judgment below at 350. In fact, respondent mined the coal to exhaustion without any exercise of the termination clause which is the focal point of this litigation.

By placing emphasis on the fact that certain lease arrangements are subject to short notice terminations, the Tax Court at least has put itself in a position of having to determine how long is short. Is thirty days short? Is a sixty-day period short? Is a one hundred twenty-day period short? See *Weaver* v. *Commissioner,* supra, for a situation where one hundred twenty days' notice was apparently adequate because on the facts with respect to that particular lease, one hundred twenty days was long enough for the lessee to mine the deposit to exhaustion. But what difference does it make whether a taxpayer who has a leasehold interest in the minerals in place and has to look to the market to recover his investment holds that lease subject to a short-term notice termination clause? For as long as he owns that leasehold, he

has all the right, title and interest to mine the coal and sell it to whomever he pleases. Under *Palmer,* that constitutes an economic interest although it may not last more than one day.

In summary there is no policy reason why under percentage depletion rules the lessee must have the right to mine the deposit to exhaustion. Certainly if the lessee has the right to mine the coal and depends upon the market for recovery of his investment and that right lasts only for one day, then at least for that one day he has borne all the risks of ownership in recovering his investment in the minerals by producing and selling on the open market. The lessee does not calculate his depletion based on estimates of units in the ground but, rather, by a percentage of income generated by the sale of the mined coal. The requirement of mining to exhaustion under percentage depletion is misplaced through a loose application of the *Palmer* v. *Bender* rule. The fact that there is a termination clause which is a condition subsequent to an otherwise valid economic interest ought not to affect that interest because until it is exercised, the lessee bears all the risks of ownership and must look to the production and sale of minerals in the open market place to recover his investment. That is all that *Palmer* v. *Bender,* supra, ever required. Here, the government has conceded that respondent has all indicia of an economic interest but for the termination clause. Until the termination clause is exercised (and it never was), the lessee has the exclusive right to mine and sell on the open market for his own benefit. That is an extremely valuable right until it is terminated.

III. Economic Reality Is The Touchstone In All Tax Cases

The termination clause at issue in fact was never exercised over the period during which respondent completely mined the coal under the lease. Quite clearly, then, the respondent had an interest in fact which permitted it to mine the coal to exhaustion. If and until the termination clause had been exercised, respondent had the requisite economic interest to permit its taking the depletion allowance.

In the judgment below at page 350, the Court of Claims stated that "the mere existence of the unused termination clause is not enough to deprive the taxpayer/lessees of their 'economc interest' they would otherwise have." This statement is based on the economic reality that until the termination clause is exercised, the lessee has every right to mine the coal and sell it on the open market, taking the risk of profit or loss upon itself and not looking to the lessor for payment which would amount simply to compensation for mining services rendered.

On page 351 of the judgment below, the court dealt again with economic substance and not technical form. The court looked to the records which "show that each of the taxpayers had regularly mined coal from the leases in question for a very substantial period prior to the taxable years [footnote omitted] and that, in all reality, they had a very good expectation of being able to continue to do so. In Nos. 403-75 and 400-77, we accept the showing that the lessors rarely (if ever) terminated without cause, not as demonstrating that the lessors lacked the legal power to terminate without cause [footnote omitted], but solely as showing that in practice and in reality the plaintiff coal-lessees had, at all rele-

vant times, a solid expectation that they could continue under their leases to mine the coal for a substantial period and to extract a substantial amount of the coal [footnote omitted]. This means — unless we are to depart from defendant's own norm for testing 'economic interest' by substance and reality, rather than by mere nomenclature or the theoretical form of the legal arrangement — that taxpayers are entitled to depletion. They satisfy the proffered criterion of knowing in advance that they will be able to mine for a substantial period and to extract a substantial portion of the coal. Certainly this was true at the beginning of each of the taxable years."

At 636 in *Bakertown Coal Co.*v. *United States,* supra, the court indicated its agreement that economic reality must be taken into consideration. It said:

> The property interest represented by that authority [that is, the authority over extraction and sale of minerals given pursuant to leases] is not varied or diminished simply because the authority is subject to the possibility of extinction in the future by a termination of the leases on short notice. The legal effect of a termination on these leases is no less prospective because the advanced notice requirement is only 30 days, than it would be if the specified period were one year.

Despite the government's argument to the contrary at pages 21-22 of its brief, as pointed out in the judgment below, there was no danger that, if the lessor could obtain a better royalty, the lessor would terminate the lease. Even though it is a fact that the market has increased substantially, no such action was ever taken because reality dictated that the lessor remain bound under the then existing lease. 602 F.2d 348 at 351 footnote 9.

Therefore, based on the reality existing in this case 1) that respondent mined the deposit to exhaustion without exercise of the termination clause by the lessor, 2) that the parties never had any intention of exercising that clause, 3) and that even though the price for coal has risen dramatically, the lessor never terminated the lease, the termination clause had no true economic significance in this case.

IV. The Lessor Has Not Claimed Any Depletion Allowance With Respect To The Coal Mined By The Lessee During The Tax Year In Question: Hence the Lessee Is Entitled To The Depletion Allowance Since Congress Did Not Intend That No One Be Able To Claim The Depletion Allowance.

If respondent is not entitled to the allowance for percentage depletion, there will be no depletion allowed on the coal mined under the lease. No claim for percentage depletion has been made by the lessor (Lindsley Deposition, page 9). The lessor did take capital gains on royalties under Section 631(c) of the Internal Revenue Code of 1954, as amended, (*id.*, 16).

The denial of percentage depletion to respondent where, as in this case, there are no other possible claimants, would bring about an untenable and inequitable result, clearly contrary to the intention of the Congress in enacting the "equitable apportionment" provision, Section 611(b)(1) of the Internal Revenue Code of 1954, as amended, *infra,* at 1a.

The deduction for percentage depletion is mandatory in all cases where it exceeds cost depletion, and it must be computed on the basis of an arbitrary percentage (in the case of coal, 10%) of the "gross income

from the property." Section 613 of the Internal Revenue Code of 1954, as amended. In 1951, Congress provided capital gains treatment for the recipients of coal royalties, in lieu of percentage depletion (Revenue Act of 1951, Section 325, P.L. 183, 65 Stat. 452, 501-2, the predecessor of Section 631(c) of the Internal Revenue Code of 1954).

Ever since that time, only lessees of coal lands and others similarly situated — i.e., those who have acquired an "economic interest" through arrangements other than leases — are entitled to any amount of percentage depletion. Both Section 631(c) of the Internal Revenue Code of 1954, as amended, Appendix, *infra*, at 2a, and Treas. Reg. Sec. 1.611-1(b)(2), Appendix, *infra*, at 4a, clearly specify that coal lessors and sublessors not actively engaged in the mining or preparation of coal are entitled to capital gains treatment instead of percentage depletion.

It is not within the province of the Commissioner, contrary to the statutory provisions above cited which are clear on their face, to completely eliminate depletion on a portion of the gross income from the coal property — that is, on the difference between the selling price of the coal and the royalty paid by the lessee to the lessor — as he has attempted to do in this case.

In *Paragon Jewel Coal Company, Inc.* v. *Commissioner,* supra, at 636-7, this Court thoroughly considered the provisions of Section 631(c) of the Internal Revenue Code of 1954, as amended, Appendix, *infra*, at 2a, and clearly indicated that "an owner who by contract disposes of the coal in place while retaining an economic interest is relegated to capital gains treatment of the royalties received," unless he is actively engaged in the mining of coal, in which case he is entitled to percentage

depletion. By no possible interpretation of the statutory provisions could the lessor in the instant case be considered to be within the "exemptive language in Section 631(c)," referred to by the Court in *Paragon* so as to be entitled to any portion of the percentage depletion allowance on the coal mined from the leases.

CONCLUSION

The judgment of the United States Court of Claims should be affirmed

Respectfully Submitted,

Woodrow A. Potesta

Attorney for Respondent
Bull Run Mining Co.,
Inc.

September 19, 1980

APPENDIX

APPENDIX

Internal Revenue Code of 1954, as amended (26 U.S.C.):

Sec. 611. Allowance of Deduction for Depletion

(a) *General Rule* — In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance in all cases to be made under regulations prescribed by Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treaded as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) *Special Rules*

(1) *Leases* — In the case of a lease, the deduction section shall be equitably apportioned between the lessor and the lessee.

Sec. 613. Percentage Depletion

(a) *General Rule* — In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 *shall* be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the tax-

able income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

Sec. 631. Gain or Loss in the Case of Timber, Coal or Domestic Iron Ore.

(c) *Disposal of Coal or Domestic Iron Ore With a Retained Economic Interest* — In the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor. The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and

royalties shall be determined without regard to the provisions of this subsection.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.611-1. Allowance of Deduction for Depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timer* — (1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil, and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion basis of the property (see section 612, relating to coast depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the xtraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner

of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or domestic iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631(b) or (c).